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*R*ussia Increasingly Influential in the Global Diamond Market



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Russia Increasingly Influential in the Global Diamond Market

Summary

President Putin's decision last year to deregulate the diamond industry, as part of the government's effort to comply with WTO rules, set the stage for Russia to exercise its market power in the diamond trade. Russia mines about 20 percent of the world's rough diamond output and, until recently, had allowed the international diamond conglomerate De Beers to control most of its exports. Russian mining giant Alrosa and many cutting enterprises have responded to deregulation by setting up direct marketing arrangements with foreign customers.

- *Growth in export revenues, however, will depend on whether foreign demand continues to expand rapidly enough to absorb an expected surge next year in output from new Canadian mines.*

Russia used its clout as a major diamond producer to help scuttle a proposal to set up an international enforcement agency in the Kimberley Process—an international initiative to stem the sale of diamonds by African rebel groups and their allies. The Russian delegation succeeded in convincing others that a country-based enforcement program was cheaper and less intrusive on national sovereignty than the competing proposal. *Because Russia has the potential to be a major conduit for moving smuggled diamonds to market, its ability to implement an enforcement regime will be central to an international effort to shut down this method of financing insurgent and terrorist activities.*

- Russia's porous southern borders, internationally connected Islamic insurgency in Chechnya, and extensive criminal networks provide opportunities to turn smuggled diamonds into cash

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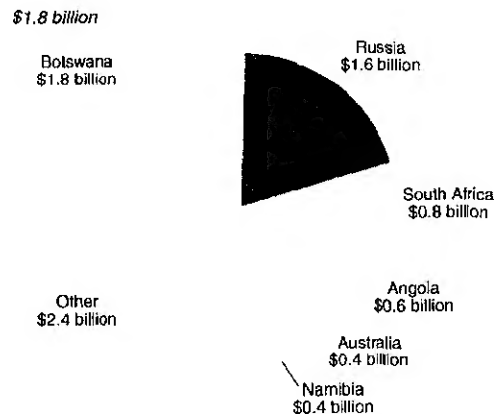
Russia Increasingly Influential in the Global Diamond Market

President Putin's government has taken steps in recent months to reduce the role of foreign middlemen in the marketing of Russia's diamonds. Most rough and polished Russian diamonds are exported, earning an estimated \$1.8-2 billion in 2002. The Russian President set the stage last year for loosening the country's Soviet-era reliance on the marketing services of international diamond giant De Beers when he signed a decree deregulating the diamond industry, as part of Russia's program to align its regulations with WTO standards.

- Under the decree's provisions, diamond mining and cutting enterprises gained the right to sell rough diamonds directly in foreign markets.
- The revival last year in global demand for gem quality diamonds has encouraged Russia's producers to be more aggressive in marketing, according to press reports.

The Russian Government's moves to allow its producers to circumvent its traditional diamond marketing channels came at about the same time that the European Commission put a hold on Russian diamond mining giant Alrosa's agreement with De Beers to market \$800 million in exports of rough diamonds annually. The Commission raised questions about whether the agreement complies with EU competition rules. The Luxembourg-registered De Beers company already controls 60 percent of global output of rough diamonds through its mining interests in Africa, and its agreement with Russia would boost that to 70 percent, according to press reports. The Commission's final ruling is due this fall, but it has indicated to Alrosa that it would be wise to develop other marketing channels, the Russian media reports.

Russia Placed Second in Global Output of Rough Diamonds Last Year



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- Alrosa has set up sales offices in New York and London, and earlier this year, it signed a deal with the Lebanese conglomerate, Horizon Development, for its assistance in selling \$500 million in rough diamonds per year in the Middle East.
- To take greater advantage of the 12-16-percent markup on cut diamonds, Alrosa reached an agreement this summer with a US company to set up a joint venture in Russia for processing rough diamonds, which could boost Alrosa's exports of cut diamonds from \$120 million to \$500 million per year, according to the Russian press.

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ALROSA also is working with independent Russian diamond-cutting firms in the Diamond Chamber of Russia—an association chaired by ALROSA Vice President Ulin that also includes Russia's largest cutting firm, Kristall of Smolensk, and some 40 other enterprises. The Chamber has signed an agreement with Antwerp's Diamond Council that gives Chamber members direct access to market their stones in Belgium's major diamond trading center.

- The Russian Government's decision earlier this year to switch from a one-year to a five-year export quota regime has facilitated the efforts of ALROSA and major cutting enterprises to develop long-term marketing relations with foreign customers.

Russia's big two cutting enterprises are well positioned to push exports. Kristall has established outlets in Hong Kong, London, New York, and Tel Aviv, and Russia's second-largest cutting firm, Ruiz, is part of a global conglomerate based in Israel.

Many of Russia's small diamond-cutting enterprises also have close ties to overseas clients. Several foreign firms use a tolling scheme—in which they fund Russian cutting firms' purchases of rough diamonds and take the polished diamonds as payment—that accounts for about half of the rough diamonds cut in Russia, according to industry experts.

- In response to overseas demand, Russian diamond cutters last year adopted world standards for grading stones, according to press reports.

Taking Lead on Global Regulations

Exercising its clout in the global diamond market, Russia was in the forefront of a successful effort during Kimberley Process negotiations to torpedo a plan that would have created an international enforcement agency to suppress the trade in "conflict diamonds" smuggled out of insurgency areas of Africa. Moscow publicly branded the initiative as too costly and intrusive on national sovereignty and backed a

The Kimberley Process

The UN in 2000 sponsored an initiative to block cross-border trade in diamonds smuggled out of insurgent areas of Africa to finance arms purchases. These "conflict diamonds" account for 2 to 4 percent of global trade in rough diamonds, according to industry experts. Diamond-producing and -consuming countries, which account for 90 percent of the trade in rough diamonds, as well as nongovernment organizations participated.

Under the certification scheme launched worldwide on 1 January 2003, rough diamonds may only be transported across frontiers in sealed containers and must be accompanied by a certificate of origin from the producing country attesting that they were mined outside of African insurgency areas.

The WTO General Council in May granted the Kimberley Process a waiver allowing signatories to refuse to trade rough diamonds with nonsignatories and with signatories that fail to enforce the certification regime.

successful compromise diamond certification system based on individual country legislation and industry self-regulation.

- Russia demonstrated its commitment to the Process by being among the first governments this spring to issue regulations implementing the certification program.

Looking To Keep Lid on Smuggling

Moscow has acknowledged difficulties controlling diamond smuggling and called on the international community to tackle worldwide smuggling.

[REDACTED] The Russian Government reports that as much as a quarter of the \$800 million in rough diamonds allocated to local cutting enterprises are smuggled out of the country, *depriving Moscow of an estimated \$10 million in export duties.*

[REDACTED]

Furthermore, a provision of the deregulation program will give diamond cutters a new informal export channel. Beginning this year, they are permitted to send diamonds duty-free out to foreign cutting centers with the understanding that they will be returned for additional processing. According to investigative reporting by the Russian press, several diamond-cutting enterprises in the mid-1990s used this "give-and-take" scheme to transfer out the bulk of their large, gem-quality rough diamonds and replaced them with smaller stones smuggled in from Africa until Moscow banned the practice.

- *Taking advantage of the current give-and-take regime, foreign cutting enterprises, for example, could process the rough Russian diamonds and set them in jewelry, which does not require certificates of origin, and then return smuggled diamonds to the Russian enterprises with the certificates that had accompanied the Russian stones.*
- Small Russian diamond-cutting enterprises are especially likely to engage in such smuggling schemes because these companies are chronically short of working capital, according to industry observers.
- Russia's largest cutting enterprise, Kristall is headquartered in Smolensk, an oblast with a reputation for corruption and smuggling that is on the main road connecting Russia with Western Europe.

[REDACTED]

The Baltic states have provided conduits for illegal diamond exports. Latvian banks used their diamond export licenses to funnel diamonds smuggled from Russia into legal trade channels, and Estonia has a reputation as a transshipment point for the illegal exports of Russian precious metals and stones, according to press reports. *Until they join the Kimberley Process, however, middlemen in Latvia and Estonia will face more difficulty "laundering" diamonds because the major cutting centers are in signatory countries, and they may not import diamonds from nonsignatories under Process terms.*

[REDACTED]

Uncertain Way Forward

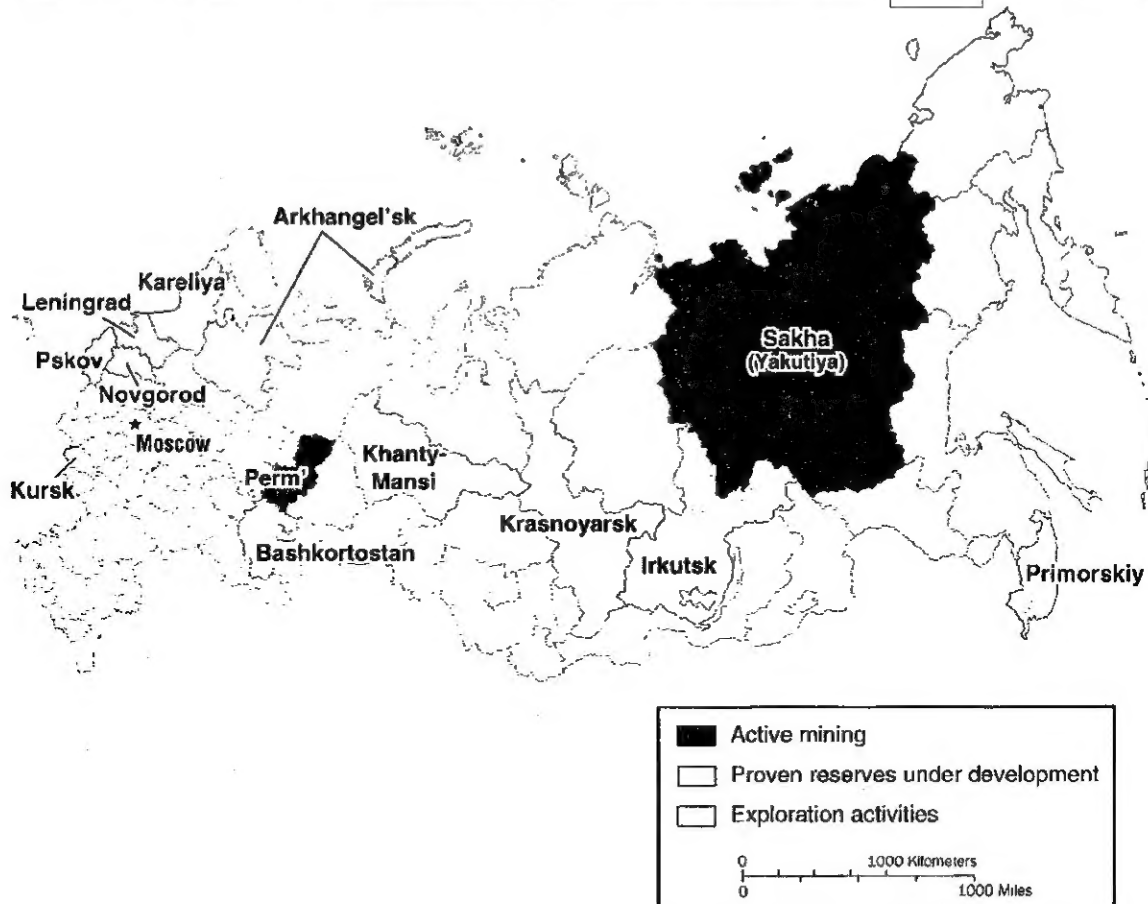
Arosa's commitment to developing new diamond fields probably will ensure that Russia remains a major producer of rough diamonds for many years to come. Growth in export revenues, however, will depend on Russia increasing the portion of polished to rough diamonds it sells overseas and foreign demand for gem-quality stones growing fast enough to absorb a surge in Canadian mine output predicted for next year by industry observers.

Russia's future influence in setting international policy to control smuggling will depend, in part, on whether it can demonstrate a good-faith effort to implement the Kimberley Process certification program. Although Russia's position as a large producer will always give it a seat at the table,

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Appendix

Diamond Mining Activity in Russia



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Russia has the largest proven diamond reserves in the world, and the Sakha Republic in eastern Siberia is the site of most of the country's diamond mining. Because they have been in operation since the 1950s, however, most of the open-pit mines are near exhaustion, forcing diamond-mining companies to explore and develop new fields.

Almost all Russian diamonds are exported. The Almaz Rossii-Sakha Company (Alrosa), which mines 99 percent of Russia's diamonds, sells half of its rough stones overseas, and provides most of the rest to domestic diamond cutters. These cutting enterprises, in turn, export 97 percent of their output. The Russian State Depository for Precious Metals

Some 40,000 people out of Sakha's population of 1 million work at Alrosa. Its fees for mining rights fund 70 to 80 percent of the Republic's budget, and the company's promissory notes make up a substantial informal component of the Sakha's money supply, according to press reports.

Rising production costs, as the company switches from open-pit to subsurface mining, are calling into question whether Alrosa can maintain its goal of making \$200 million in profits annually, according to industry analysts. They predict that Alrosa will have to invest \$1 million in developing underground mines in the Arctic region just to replace the Udachnaya open-pit mine, which provides 65 percent of Alrosa's current output.

and Precious Stones (Gokhran), which is under the Finance Ministry, buys small portions of Alrosa's output, which it later resells to domestic and foreign buyers to raise funds for the government.

- Alrosa also has launched plans to upgrade the facilities and increase production at its Catoca mine in Angola, where mining costs are half those in Russia; the mine is a joint venture with the government of Angola and one of Levayev's companies.

The federal government controls key parts of the diamond sector, and senior officials have signaled that they want to maintain a grip on the diamond trade. The government retains 100-percent ownership of the Kristall cutting enterprise in Smolensk, the largest diamond-polishing firm in Russia, and has postponed privatization plans. The Russian Government owns 37 percent of the closed-stock company Alrosa, and the Sakha Republic holds another 32 percent of the firm's shares. The rest of the equity is divided among employees and local governments in Sakha.

Alrosa has enhanced its reputation as a Russian blue-chip asset by rolling over some of its \$1.1 billion ruble debt into longer term, lower interest foreign debt instruments. Last year, Alrosa secured a \$91 million loan from a consortium of Western banks.

- Finance Minister Kudrin, who chairs Alrosa's Supervisory Board, has justified a decision to indefinitely delay plans to open the company to private investors, saying that Alrosa has to continue allocating half of its earnings to social infrastructure in Sakha.
- Moscow's decision last year that valuable natural resources such as diamonds, gold, and oil remain federal property further reduces the likelihood that Alrosa will be privatized soon.

- Earlier this year, Alrosa's \$300 million Eurobond issue was oversubscribed, allowing Alrosa to raise the amount to \$500 million. Moodys rated the ALROSA bond, "B3," and S&P gave it a "B," just below investment grade.